No. 10,087

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

MINNIE L. WHITTHORNE and EVA WHITTHORNE, Executrices of the Estate of W. R. Whitthorne, Deceased,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent,

and

SHERWOOD SWAN,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

REPLY BRIEF OF PETITIONERS-APPELLANTS.

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Not petitioners

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REPLY BRIEF OF PETITIONERS-APPELLANTS.

I. THE TAXPAYERS DID NOT RECEIVE TAXABLE GAIN IN 1936 BY THE SETTLEMENT WITH THEIR BANK CREDITORS.

This is an effort to collect from appellants tax on "negative income". "Negative income" is a phrase coined by Paul & Mertens to describe a situation like the present one where a taxpayer has not received any real income but is simply less involved financially than he was before by reason of the act of his creditors in

the cancellation of part of his indebtedness. (Paul & Mertens on Income Tax, Sec. 743.)

1. STOCK WAS FREED IN 1930 FROM ALL DEBT IN EXCESS OF $200,000.00; NO FURTHER FREEING WAS ACCOMPLISHED IN 1936 EXCEPT $5000.00.

Counsel for the Government concede on page 17 of their brief that the only basis for treating a cancellation of debt as taxable income is the "freeing of assets" involved. Yet they argue on page 19 that because the debt was still carried after 1930 on the balance sheet as a liability, the rule is inapplicable. They further contend that the equity in such stock was still held for the payment of the bank debt. This is not correct. It was not merely partially released from pledge. The taxpayers could have obtained the freedom of their stock without further pursuit at any time upon payment of $200,000.00.

Counsel admit that the only theory upon which the transaction can be characterized as income at all is that the taxpayer has something usable and "free" that he did not have before. Before 1930 the taxpayers' stock was hopelessly encumbered by $445,000.00 of bank debt. After that partial freeing it was encumbered only to the extent of $200,000.00. In other words it was more than one-half freed from its load of debt, and to that extent was more usable to the taxpayer. Suppose the creditors in 1930 had freed the stock from all pursuit except to the extent of $1.00 (instead of $200,000.00), certainly the Government could not contend that the assets were not substantially freed in 1930. So here the stock was freed in 1930 of 55% of its burden, leaving only $200,000.00 to be paid off in

1936. The taxpayers in fact paid no more than $195,000.00 in 1936 so that the stock was only freed of $5000.00 of cancelled debt in that year.

2. ANY INCOME TO PETITIONERS INCIDENT TO THE RELEASE OF ASSETS OCCASIONED BY THE CANCELLATION OF INDEBTEDNESS CANNOT EXCEED THE COST BASIS OF SUCH ASSETS OF PETITIONERS.

There is conflict between counsel for the Government and ourselves as to the meaning of "insolvent" as used in such cases as *Madison Railways Co. v. Commissioner,* 36 B. T. A. 1106. The Government urges that it has the same meaning as "insolvent" in the Bankruptcy Law, i.e., the condition of having assets which at a fair value are not sufficient to pay debts.

However, they do not find a single case in which the assets in such a debt cancellation transaction have been computed at a figure in excess of costs. They cite *Commerce Trust Co. v. Woodbury,* 77 Fed. (2d) 478, and *Haden Co. v. Commissioner,* 118 Fed. (2d) 285. The first case is not a tax case at all but a fraudulent transfer under state law. In *Haden Co. v. Commissioner* the Court does not state on what basis it is figuring the value of the assets. The fact that an uneven figure is used—$149,644.98—is some indication that it was book value. If it was figured as the result of an appraisal of present fair value it would more likely be an even figure. But the case is not of any help because it does not indicate its basis.

We believe that it is demonstrable that cost is the only basis that can be justifiably used. May we make our point clear by a series of illustrations:

a. Assume a taxpayer's sole asset is stock which cost him $5000.00 and which is now worth $10,000.00 and which is pledged to the bank to secure $100,000.00 debt. Assume the bank cancels $50,000.00 of his debt. In spite of such partial relief he receives no taxable income because his stock is still subject to the burden of the remaining $50,000.00 of debt.

b. Assume the bank cancels $95,000.00 of the debt, leaving only $5000.00 due. Still the taxpayer will not have received income because his $5000.00 stock is still subject to the burden of the remaining $5000.00 debt. It is true that he can, if he wishes, go out and sell that stock for $10,000.00, pay off his debt and have $5000.00 profit. But it is the act of selling the stock at a price above cost that creates that profit, not the prior act of the creditor's cancelling the debt. For if the taxpayer does not immediately sell his stock but waits a year until its price again goes down to $5000.00 and then sells it he will make no profit. Until such actual sale any possible profit is "unrealized" and is so uncertain of receipt that the income tax act does not recognize it.

c. Assume that the bank cancels the entire $100,000.00 of debt. Then the taxpayer will immediately realize $5000.00 income occasioned by his $5000.00 stock being freed from the burden of debt. The other $5000.00 income he will receive, not because the stock is freed from debt, but only because he immediately elects to sell it for $10,000.00 at a profit over cost. Until he does so elect to sell it, he does not receive that second item of profit.

Any other basis would be inconsistent with the theory of the law that only realized income is to be

taxed. Furthermore, if the freed stock should be valued at its present value instead of cost, then it would have to follow that such "steeped up" basis be used as the basis of the stock on any future sale. Otherwise the same increment in value would be taxed twice—once when the stock is released from debt and again when the stock is sold. That is exactly what the Commissioner is attempting to do here. In determining whether there was any profit on the debt cancellation he uses, not its cost but what he regards as the then market value of the stock, but when he is determining the profit realized on the sale of that stock a few days later he does not use that "stepped up" basis but reverts to the original cost of the stock and taxes the difference between the sale price and such cost. Accordingly he is taxing twice the difference between his estimate of the then market value and the original cost.

Applying the cost basis (which we have shown is the proper one) to the tables appearing on pages 26 to 28 of our opening brief, it is clear that neither taxpayer received any taxable income as a result of the cancellation indebtedness during the year 1936.

3. THERE WAS NO CANCELLATION OF INDEBTEDNESS BY BANK OF AMERICA IN 1936.

An examination of the findings (Record, pages 79-80) shows that the arrangement worked out with the receiver of the Central National Bank in December, 1936, was in fact a cancellation of indebtedness. A far different method, however, was used in the case of Bank of America. There was in that case no com-

promise involving a partial payment of indebtedness with forgiveness of the balance. On the contrary the findings (Record, page 80) and the evidence (Record, pages 213 to 217) shows that that bank conducted a formal pledgee's sale. At such sale the Sherwood Swan and Company stock was purchased by Sherwood Swan for $100,000.00. The remaining securities were then offered for sale by the party conducting the auction and were bid in by the bank for an amount equal to the full remaining indebtedness, both principal and interest, from the taxpayers to the Bank of America—$96,073.14. The party conducting the sale thereupon declared that the amount so bid constituted "full payment" of the notes and delivered the notes to the taxpayers marked "Paid". Clearly if a third party had purchased the pledged securities for the full amount of the indebtedness the bank would have been paid in full and there would have been no cancellation. There is no difference merely because the bank itself as purchaser bids at the pledgees' sale for an amount equal to the full amount of the indebtedness. It is true that the Board of Tax Appeals declares that the pledged securities purchased by the bank, other than the Hale Bros. Realty stock, were worthless. That is immaterial. The bank determined that it wanted them badly enough to bid $96,073.14 for such securities including the Hale Bros. stock.

This clearly constituted a payment in full of the indebtedness and not a cancellation so far as the Bank of America indebtedness was concerned.

4. THE CANCELLATION BEING WITHOUT CONSIDERATION DID NOT CONSTITUTE INCOME TO THE TAXPAYERS.

Since the filing of the opening brief in this case the decision of the Seventh Circuit Court of Appeals in *American Dental Co. v. Commissioner,* 128 Fed. (2d) 254, has been published. That case is almost directly in point and lays down the rule that where a cancellation of indebtedness is made without consideration it does not constitute income. The tenant was there heavily indebted to his landlord who said to him, "Well, pay me $7500.00, and I will call it square, and forget the rest of it." The tenant answered, "Well, I haven't $7500.00." The landlord replied, "You worry about raising the $7500.00; get busy and raise it and pay it when you can, and forget the rest of it." That conversation was in 1933 and was substantially similar to the arrangement made between the present taxpayers and the banks in 1930. In the *American Dental Company* case the $7500.00 was paid in 1937 just as the agreed payments were made to the banks by taxpayers in the present case in 1936. In determining that the cancellation did not result in any income to the debtor, the Court said:

> "There was no consideration to the landlord for the cancellation of the debt. * * * It forgave all but $7,500 of the rent for no consideration whatsoever to the landlord, and merely as a benefit to the debtor. * * *
>
> "Since, therefore, there was no consideration for the cancelled debts, and the concellations inured only to the benefit of the debtor, the amount of the debts as cancelled is a gift from the creditors to the debtor, within the meaning of the

> Treasury Department's regulations, and the debtor was not required to include it in gross income."

The Court held that the Board of Tax Appeals was erroneous in requiring evidence of donative intent, saying:

> "Suppose the creditors did act for purely business reasons. As long as there was no consideration for the cancellation, the intent to give necessarily followed. Evidently the Board confused intent with motive. * * *
>
> "Our decision may result in the Government getting no tax, although the taxpayer had benefited by deducting the rent and interest accrued. * * *
>
> "The unfairness of the Government's position is evidenced by taxing this sum of $19,234.21 as excess profits received in 1937. Of course, the taxpayer never received a nickel it could have distributed as dividends. It received cancellation of debts for services and goods already consumed. How it could have distributed that as a dividend is not apparent. It is not difficult to imagine what would have happened to this debtor-taxpayer if it had inveigled its creditors into cancelling these debts on the basis that the debtor was hard up and then the debtor had distributed a like amount in dividends!
>
> "We therefore hold that the indebtedness was cancelled for the benefit of the debtor and without consideration, and was not taxable. The decision of the Board of Tax Appeals is Reversed."

This case exemplifies the present thinking on this subject of taxing "negative" but unearned or unrealized income.

II. IN DETERMINING WHETHER ANY CAPITAL GAIN WAS REALIZED ON THE SALE OF THE CLASS A STOCK, ALL THE COST BASIS SHOULD BE ALLOCATED TO THAT STOCK AND NONE TO THE COMMON STOCK SINCE THE LATTER HAD NO FAIR MARKET VALUE.

This point was developed under heading VI of our opening brief on pages 25 to 30 thereof. We analyzed the facts of the reorganization, the circumstances of the conversion of the old stock, showed that these facts were exactly similar to the facts in *Axton v. Commissioner,* 32 B. T. A. 613, and that therefore the rule of the *Axton* case should apply to the effect that all the cost bases should apply to the Class A stock on the ground that the common stock had no fair market value. Counsel for the Government recognize the similarity of the *Axton* case to the present one. Their only effort to distinguish it is to claim that in the present case the Board found that the new common shares had substantial value. This is not correct. In the *Opinion* of the Board there are certain comments as to why the Commissioner allocated cost between A stock and common stock (Record, pages 88 and 89), but a careful study of the *Findings* shows that there is no finding whatever as to the value of the common stock or as to whether it had any market value.

The cases are clear that a statement in the Board's opinion cannot be considered as a substitute for a missing finding of fact. See *Commissioner v. Bonwit* (C.C.A. 2nd) 87 Fed. (2d) 764, where the Court said:

> "The Board's opinion states that 'there is no evidence that he or his employer intended or regarded them'—premium payments—'as addi-

tional compensation,' and the respondent rightly asserts that this Court is bound by the Board's findings on questions of fact, if they find any support in the evidence. The Board's formal findings of fact make no reference to additional compensation, but do include a finding that the records of the corporation contain no resolutions pertaining to the policies, nor any agreement between the corporation and the respondent respecting them. The above-quoted sentence from the opinion was perhaps intended as a reference to the absence of evidence in the corporate records. * * * We are at liberty, therefore, to disregard the above-quoted statement from the opinion, if it may be considered as a finding of fact."

For the failure of the Board to find on such an essential issue the Court reversed in *Belridge Oil Co. v. Commissioner,* 69 Fed. (2d) 432. The Court there said:

"The 'findings of fact' of the Board of Tax Appeals are concerned largely with the recital of probative facts. There is no finding therein of the actual cash value of the option. It is only from the statements in the opinion and from the fact that judgment was entered for the respondent, and from the dissenting opinion which construes the majority opinion as holding that the actual cash value of the option was only $25,000, that the actual cash value of the option is to be inferred.

"It is the duty of the Board of Tax Appeals to find the facts upon which the validity of the proposed deficiency tax depends. Upon the petition to review, we are concerned only with the

question as to whether or not the facts found sustain the legal conclusions deduced therefrom. * * *

"All that we have said in this matter is for the purpose of emphasizing the fact that there is no direct finding by the Board of Tax Appeals on the ultimate fact involved in the determination of this appeal, and, consequently, that the case must be returned to them for such a finding."

In the light of this decision this Court can either now treat the case as exactly similar to the *Axton* one or reverse it with directions to the Board to make findings as to whether the common stock had any fair market value.

None of the cases cited by counsel for the Government on page 23 of their brief are at all helpful.

In *Baker v. Commissioner,* 115 Fed. (2d) 987, the common stock had been sold to forty-one employees, thus fixing a market value for it. See the case as reported before the Board in 37 B. T. A. 1135 at page 1155.

In *Salvage v. Commissioner,* 76 Fed. (2d) 112, the Court declared "there can be no doubt it could have been sold if offered." There is no evidence in the present case of any similar possibility of sale of the common stock.

In *Curtiss v. Commissioner,* 57 Fed. (2d) 847, each of the two securities was sold within a few months after the exchange, thus furnishing a definite standard of market value.

In *Houghton v. Commissioner,* 71 Fed. (2d) 656, the Board had been able to find a market value for

the common stock by the application of a formula, taking into consideration the application of a portion of average earnings to tangible assets and the balance to intangible assets. There was no basis for any similar formula here nor was any such formula set up.

In *Collin v. Commissioner,* 32 Fed. (2d) 753, the case was reversed and returned to the Board to take evidence as to the value of the common stock.

III. PETITIONERS SHOULD BE RELIEVED FROM THE FIVE PER CENT PENALTY FOR THE ALLEGED ONE-DAY DELAY IN FILING THEIR RETURNS.

The taxpayers' returns were due under their extensions of time on June 1, 1937. The return of one of the taxpayers as introduced in evidence (Respondent's Exhibit "B") bears the Collector's stamp:

"FILED
6/2 37
Collector of Internal Rev.
First District Calif.
Deputy SWAS"

Mr. Swan testified (Tr. p. 124) that his general recollection was that the returns were taken by him to the Internal Revenue Office in the Post Office Building, Oakland, and an attempt made to file them on June 1, 1937, the due date; that they were slipped through the slot in a door in the office late in the afternoon of that day.

The rule is that the Board will relieve from penalty for late filing if there is "reasonable cause" for the

delay. Such reasonable cause is defined in *Pearsoll v. Commissioner,* 29 B. T. A. 747, as "such cause as would prompt an ordinary intelligent and prudent businessman to have so acted under similar circumstances." An ordinary intelligent and prudent businessman in this community knows that all city and county offices are open until 5:00 o'clock as required by law.

> *California Political Code,* sections 1030 and 4312.

He knows that the United States Post Office (in the same building as the United States Collector of Internal Revenue) is open until 6:00 o'clock.

Under such circumstances it was not unreasonable to expect that the office of the Collector of Internal Revenue would remain open until 5:00 o'clock and that a taxpayer might with propriety file his return up until that hour. Finding the office after 4:00 o'clock locked, it was not unreasonable to slip the returns with a check for the amount of tax shown due on Mrs. Swan's return through the slot in the door provided for that purpose.

This was such cause as would prompt an ordinary intelligent and prudent businessman to have so acted under similar circumstances.

Counsel for the Government cite only four authorities none of which is in point. The first two—*United States v. Lombardo,* 241 U. S. 73 and *Poynor v. Commissioner,* 81 Fed. (2d) 521, merely hold that placing in the mail is not filing. Of course it is not. Incident to such determination the Court states that a paper

is filed when it is delivered to the proper officer and "received". But this does not mean that a paper can be prevented from being filed when it is left in the proper office merely because the deputy in charge has locked his door at 4:00 o'clock in the afternoon.

The other two cases cited by counsel for the Government are inapplicable.

In *J. K. McAlpine Land & D. Co. v. Commissioner,* 126 Fed. (2d) 163, no evidence whatever was offered to excuse the delayed filing which was many months delinquent. See the case in 43 B. T. A. 520.

In *West Side Tennis Club v. Commissioner,* 111 Fed. (2d) 6, the only justification offered was that the taxpayer "believed" it was exempt.

In the present case the taxpayers made a valid effort to file their returns by leaving them at the appropriate office on the afternoon of the due date. The returns are not made delinquent merely because the Collector later stamped them with the succeeding day's date.

?

CONCLUSION.

The Government is entitled to prevail because:

1. It is endeavoring to treat the transaction as a present cancellation of indebtedness in 1936 when, as a matter of fact, the stock had been freed from the burden of all but $200,000.00 of the debt in 1930.

2. It is treating the Bank of America transaction as a cancellation of debt when, as a matter of fact, it

was a purchase at pledgee's sale for the full amount of the debt.

3. It is attempting unfairly to tax "negative income"—to levy a tax upon heavily involved taxpayers merely because their burden of debt has been somewhat lightened by the voluntary act of their creditors.

4. It is attempting to tax unearned and unrealized income.

5. It is levying a double tax on the same income, first, by including it as part of the unrealized income incident to the cancellation of indebtedness; second, by including it as a part of the profit on the sale of the stock just freed from such indebtedness.

6. It is allocating the cost between preferred and common stock when, as a matter of fact, the common stock had no fair market value. Illegally allocated

7. It levied a penalty for late filing merely because the deputy collector stamped the returns the day after the taxpayers had left the returns under the Collector's door.

Dated, Oakland, California,
October 9, 1942.

Respectfully submitted,

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